

DOCKET SECTION

BEFORE THE
POSTAL RATE COMMISSION

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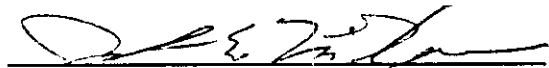
DOCKET NO. R97-1

**ANSWERS OF UNITED PARCEL SERVICE WITNESS
J. STEPHEN HENDERSON TO INTERROGATORIES OF
ADVO, INC.
(ADVO/UPS-T3-1 through 6)**

(February 10, 1998)

Pursuant to the Commission's Rules of Practice, United Parcel Service ("UPS") hereby serves and files the responses of UPS witness J. Stephen Henderson to interrogatories ADVO/UPS-T3-1 through 6 of Advo, Inc.

Respectfully submitted,



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**ANSWER OF UNITED PARCEL SERVICE
WITNESS HENDERSON TO INTERROGATORY OF
ADVO, INC.**

ADVO/UPS-T3-1. On page 10, you state,

. . . there is a good practical reason not to use incremental costs solely as a check against cross-subsidy. Without some markup over incremental cost, measurement error could lead to prices for some services that are below their actual incremental costs . . .

(a) Please confirm that you do not propose just “some markup” over incremental cost, but a specific markup index that is related to historic markups that were applied to attributable costs that did not include incremental costs.

(b) In your opinion, how much of a mark-up above incremental cost would be required in order to provide reasonable assurance that service prices are above their actual incremental costs (e.g., 5 percent, 20 percent, 100 percent)? Please explain your response.

(c) Please explain why the Commission must “mark up” incremental costs in order to ensure that service prices are above their incremental costs.

(d) Please explain why the Commission cannot account for both (1) possible measurement error and (2) incremental cost when it marks up volume-variable costs to generate a subclass price level?

Response to ADVO/UPS-T3-1.

(a) I confirm that I am proposing specific markups. These proposed markups are based on the markups recommended by the Commission in its R94-1 Opinion and Recommended Decision.

(b) It would depend on the reliability of the incremental cost estimate for each subclass. In this regard, independent work noted in my testimony on page 12, footnote 13, suggests that true attributable costs may be substantially higher than the volume

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variable costs identified by the Postal Service in this proceeding. While I do not have specific estimates of the uncertainty, I suggest it is a factor to be considered in setting postal rates.

(c) The goal is to insure that service prices are greater than *actual* incremental costs. However, the Commission recommends markups over *estimated* incremental costs. If estimated incremental costs are less than actual incremental costs and the Commission recommended no markup, then prices could be lower than actual incremental cost.

(d) Aside from legal considerations, my testimony is not that the Commission cannot do this but rather provides reasons for not doing so. These reasons include measurement uncertainty, inefficiencies associated with entry that may be encouraged over a range of postal prices as opposed to a precise (but inaccurate) point estimate of incremental costs, and legal precedent for marking up attributable costs (acknowledged by the Postal Service to include incremental costs).

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ADVO/UPS-T3-2. Please confirm that a measurement error which understated incremental cost would not, alone, cause pricing below incremental cost. It would have to be combined with a service price level that was below the true value of incremental cost. If you cannot, please explain why not.

Response to ADVO/UPS-T3-2. Confirmed.

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ADVO/UPS-T3-3. Please refer to your discussion on the bottom of page 11 and top of page 12. In part, you state:

There is another sound economic reason to mark up incremental costs. The short-run marginal cost of providing postal services for a particular subclass of mail changes frequently as a result of changes in volumes, usage mixes, overtime rates, input costs, organizational changes. . . . Short-run marginal cost pricing may be appropriate if prices could change in a short time period, such as an hour, a day, a month, or a season. When prices do not change in this manner, however, the relevant cost basis for pricing decisions should correspond to the time period during which the rates will be in effect.

The postal rates that emerge from this case are likely to remain in place for two to four years. Accordingly, the relevant costs for pricing purposes are longer run, not short run, costs. . . . Unfortunately, the Postal Service's proposed rates are based solely on costs that vary over a much shorter time period.

. . . Therefore, the Postal Service's incremental cost estimates should be used as the basis for economically efficient markups.

(a) If the USPS's rates were to remain in place for only one year (mid-1998 to mid-1999) and all USPS marginal costs were adjusted to recognize the changes in volumes, usage mixes, overtime rates, input costs, organizational changes, etc. for that time period, would you still recommend marking up incremental costs? Please explain.

(b) If long-run marginal rather than short-run marginal costs were estimated in this case (and you were satisfied that they were correctly estimated and involved an acceptably small measurement error), would you still recommend marking up incremental costs? Please explain.

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(c) Are you suggesting that the USPS estimate of incremental cost is a proxy for long-run marginal cost? Please explain, including an explanation of the differences between incremental costs and long-run marginal costs.

(d) Please explain your definition of the term "economically efficient."

Response to ADVO/UPS-T3-3.

(a) Yes. If postal prices remain in effect for a year without change, I would recommend marking up a longer run concept of marginal cost, such as the incremental cost estimates developed in this case. If postal prices varied from day to day (e.g., Saturday delivery has a higher price) or seasonally, then a short run marginal cost concept might be appropriate as an economic efficiency matter.

(b) This hypothetical question cannot be answered in the abstract without making additional assumptions, e.g., do the long run marginal cost estimates indicate constant returns to scale or large increasing returns to scale such as those estimated by the Postal Service? If the answer is closer to constant returns, then economic efficiency could be served by marking up long run marginal costs with appropriate checks against the incremental cost floor. But if the two costing concepts were substantially different, the Commission might prefer to continue marking up attributed costs (incremental costs), since changing to a new costing framework would require substantial rebalancing of the judgments that comprise its relative markup index.

(c) Yes, especially in regard to specific fixed costs as that term is used by the Postal Service. These are appropriately included as a part of both cost concepts. In contrast, scale economies could cause long run incremental cost to exceed long run marginal cost.

(d) The way I use the term "economically efficient" is well defined by William J. Baumol and Alan S. Blinder in the text *Economics: Principles and Policy* (Dryden

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Press, Sixth edition, 1994, page 67), where they write, "Economists define efficiency as the absence of waste. An efficient economy utilizes all of its available resources and produces the maximum amount of output that its technology permits."

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ADVO/UPS-T3-4. On page 12, you state:

"... the relevant costs for pricing purposes are longer run, not short run, costs. Most (if not all) of the specific fixed costs identified by the Postal Service are avoidable in the time span between postal rate cases. . . . The longer-run incremental cost concept includes the longer run resource adjustments discussed above. Thus, long-run incremental cost (rather than the Postal Service's volume variable costs) is the appropriate basis for postal markups. While not perfect, the Postal Service's estimates of incremental costs are based on this concept."

When you use the term "long-run incremental cost," do you mean the full system costs that could be avoided, assuming longer-run resource adjustments, if a particular subclass were eliminated from the system? If not, please explain your meaning.

Response to ADVO/UPS-T3-4. I used the term "long-run incremental cost" so as to include the longer term resource adjustments that would result in changes to the Postal Service's version of specific fixed costs.

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ADVO/UPS-T3-5. With respect to your statement on page 12, USPS witness Takis admits that he does not estimate the incremental costs that could be identified if remaining operations within the Postal Service are "re-optimized" or "reconfigured" as a result of eliminating a particular class or subclass (USPS-T-41, page 10). He assumes that the postal system does not change as a result of elimination of an entire class or subclass because such a reconfiguration could alter service characteristics. However, assume that if First Class Mail were eliminated, the postal system could be reconfigured to eliminate additional costs beyond those estimated by Takis. Under this assumption, would incremental cost estimates that ignore certain longer-run resource adjustments (i.e., system reconfiguration) still be considered longer-run incremental costs? Please explain.

Response to ADVO/UPS-T3-5. In my view, it is not important to be doctrinaire about this issue. If it were possible to estimate long run incremental cost or long run marginal cost for an optimally reconfigured postal system, such estimates would be improvements over estimates that accept the existing system "as is" with no such reoptimization. In practice, the effects of such reoptimization cannot be estimated reliably. I would use the best estimates available.

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ADVO/UPS-T3-6. In Exhibit UPS-T-3B, you present a table showing the results by subclass of your pricing proposals. Please provide a table in the same format showing the results by subclass assuming the rates proposed by the Postal Service.

Response to ADVO/UPS-T3-6. These results can be found in Exhibit UPS-T-3C.

DECLARATION

I, J. Stephen Henderson, hereby declare under penalty of perjury that the foregoing answers are true and correct to the best of my knowledge, information, and belief.




J. Stephen Henderson

Dated: FEBRUARY 9, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with section 12 of the Commission's Rules of Practice.


John E. McKeever

Dated: February 10, 1998
Philadelphia, PA